Nos. 92-1384 and 92-1839 (Consolidated)

IN THE
Supreme Court of the United States

OCTOBER TERM, 1993

BARCLAYS BANK PLC,
Petitioner,
v.

FRANCHISE TAX BOARD OF CALIFORNIA,
Respondent.

**On Writ of Certiorari to the
Court of Appeal of the State of California
in and for the Third Appellate District**

BRIEF OF THE COMMITTEE ON STATE TAXATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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INTRODUCTORY STATEMENT

This brief is submitted by the Committee on State Taxation as *amicus curiae* in support of the petitioner in the above-captioned matter, as well as in the matter of *Colgate-Palmolive Co. v. Franchise Tax Board*, Docket No. 92-1839, which matter has been consolidated for hearing purposes with *Barclays Bank PLC v. Franchise Tax Board*. Written consents of the petitioners and respondents have been obtained and filed with the Clerk of the Court.

INTEREST OF *AMICUS CURIAE*

The Committee on State Taxation ("COST") is a non-profit association that was organized in 1969 as an advisory committee to the Council of State Chambers of

Commerce. COST, which was separately incorporated on January 1, 1992, has a membership of over 400 major multistate corporations engaged in interstate and international business. COST's principal objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Virtually all of COST's members are engaged in business in the State of California, and many of these corporations are members of unitary groups—both foreign-parent groups and domestic-parent groups with foreign subsidiaries—that have been subject to California's worldwide reporting method. Moreover, many COST member companies were directly and adversely affected by the threatened and real retaliatory measures imposed by foreign nations in response to California's use of a taxing method that encroached upon their sovereignty. Therefore, COST has an interest in the instant case.

SUMMARY OF ARGUMENT

Every nation in the world, including the United States, has chosen to assert its taxing jurisdiction over nondomiciliary corporations by reference to arm's length/separate accounting, a method which respects the sovereignty of other nations wherein multinational corporations may conduct business giving rise to taxable income. The United States sanctions this method of taxation of foreign commerce because (i) it cannot give offense to our trading partners, but instead fosters mutually beneficial commercial and political relations; (ii) the taxing method's prerequisite that transactions cross national borders ensures that jurisdiction to tax is unimpeachable; and (iii) it has been the basis of this nation's treaty representations to foreign nations concerning the type and degree of administrative burdens and tax liabilities that the United States will impose on foreign commerce.

The foreign Commerce Clause was originally drafted and has since been interpreted by this Court to provide special protection to domestic business from any foreign retaliation that results when a state ventures on its own to tax foreign commerce in a way that, being inconsistent with federal policy in this regard, prevents the federal government from "speaking with one voice" when regulating foreign commerce. In this case, California has chosen to impugn the United States' sanctioned method of taxing commerce by imposing forced worldwide combined reporting and its concomitant administrative and compliance burdens upon many unitary foreign affiliates without any direct contact with California. This jurisdictional affront has resulted in the very retaliatory threats and measures by foreign nations that the Framers feared in a system without uniform federal regulation of foreign commerce, but that the Framers intended the foreign Commerce Clause to rectify. California's use of forced worldwide combination cannot withstand scrutiny under the foreign Commerce Clause and is therefore unconstitutional.

The practical significance of this issue to domestic business is further illustrated by the fact that several states in addition to California have adopted various forms of forced worldwide combination. These states have tools available to them to impose tax on any income of a corporation that arises from activities conducted in their jurisdictions but that has been shifted to an inappropriate taxing jurisdiction; therefore such encroachments on the sovereignty of other nations are both unnecessary and unjustifiable, by reference to the foreign Commerce Clause.

ARGUMENT

I. THE HISTORY AND PURPOSE OF THE FOREIGN COMMERCE CLAUSE AND ITS ROLE IN REGULATING THE CONDUCT OF MULTINATIONAL COMMERCE AND COMMERCIAL RELATIONS UNDERSCORES THE UNCONSTITUTIONALITY OF CALIFORNIA'S ADOPTION OF FORCED WORLDWIDE COMBINED REPORTING

Article I, sec. 8, cl. 3 of the United States Constitution reserves to Congress the power "to regulate Commerce with foreign Nations and among the several states." James Madison summarized the prevailing view of the Framers in this regard in The Federalist: "If we are to be one nation in any respect, it clearly ought to be in respect to other nations." THE FEDERALIST No. 42, at 279 (J. Madison) (J. Cooke ed. 1961). His peer Alexander Hamilton commented more specifically on the import of the federal power to regulate foreign commerce:

> The want of a power to regulate commerce is by all parties allowed to be of the number [of defects in the pre-Constitutional Federal system]. . . . The want of it has already operated as a bar to the formation of beneficial treaties with foreign powers; and has given occasions of dissatisfaction between the States. *No nation acquainted with the nature of our political association would be unwise enough to enter into stipulations with the United States by which they conceded privileges of any importance to them, while they were apprised that the engagements on the part of the Union, might at any moment be violated by its members;* and while they found from experience that they might enjoy every advantage they desired in our markets, without granting us any return, but such as their momentary convenience might suggest.

THE FEDERALIST No. 22, at 135-137 (A. Hamilton) (J. Cooke ed. 1961) (emphasis added). Foreign commerce—particularly as represented by the Union's commercial

relations with Great Britain—continued to be a focus of concern and debate at the Convention to adopt the Constitution; one analysis of the defensibility of the dormant interstate Commerce Clause doctrine notes that the Commerce Clause limits on protectionism in foreign trade and commerce in transit are much more strongly supported in the Convention records than are such limits in interstate trade. *See*, R. COLLINS, Economic Union as a Constitutional Value, 63 N.Y.U. L. Rev. 43, 54 (1988).

Concern for foreign commerce protectionism has continued to have a high profile. This Court has acknowledged that the Commerce Clause, "by its own force created an area of trade free from interference by the States" and "even without implementing legislation by Congress is a limitation upon the power of the States." *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 328 (1977). Moreover, with regard to foreign commerce, the "constitutional prohibition against state taxation . . . is broader than the protection afforded to interstate commerce . . . because matters of concern to the entire nation are implicated." *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, —— U.S. ——, ——, 112 S. Ct. 2365, ——, 60 U.S.L.W. 4582, 4584 (1992); *see also Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448 n.13 (1979) (citing other Supreme Court cases recognizing this distinction); J. HELLERSTEIN, State Taxation I, Corporate Income and Franchise Taxes ¶ 4.14[2] (1983).

This Court articulated the "more extensive constitutional inquiry" to be made where the foreign Commerce Clause is implicated by a state taxing method in *Japan Line*. Two additional considerations distinct to taxes impacting foreign commerce supplement the four-prong interstate Commerce Clause test set out in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). First, notwithstanding apportionment, the state tax may not create a "substantial risk of international multiple taxation," *Japan Line*, 441 U.S. at 451. Second, a state

tax may not "impair federal uniformity in an area where federal uniformity is essential," by preventing the federal government from " 'speaking with one voice when regulating commercial relations with foreign governments.' " *Id.* at 448, 451. Impairment of federal uinformity is demonstrated where foreign nations disadvantaged by the state tax retaliate against American-owned entities or instrumentalities present in the foreign jurisdictions. *Id.* at 450.

It has ever been the understanding of the domestic business community that the foreign Commerce Clause protected it from the ramifications of state encroachment on federal commerce regulatory powers, including the power to determine the appropriate method of taxing foreign commerce. As multi-national commerce carried on by domestic corporations has evolved and developed under the auspices of the foreign Commerce Clause and as the potential for sovereign taxing systems to encroach one upon the other becomes more significant, the need for speaking "in one voice" as to matters of taxation of foreign commerce has become even more critical. Where a state does encroach upon the sovereignty of another nation, the foreign countries that are thus disadvantaged (*i.e.*, through the imposition of economic and administrative burdens on their domiciliary business entities) typically regard such incursions as a system-wide rather than a state-specific offense for purposes of response thereto. In this case, the United Kingdom has retaliated generally against domestic business with United Kingdom contacts; only a portion of such domestic business actually has contacts with California, and that portion by their very nature will have many or most contacts elsewhere. Thus, the entire core of domestic business having nexus with retaliating nations, and the states that have taken care to observe the tenets of federal policy, bear the brunt of retaliatory measures.

Barclays has demonstrated that the retaliatory measures against which American business rightly expects the federal Commerce Clause to provide protection have occurred in this case, and will reoccur if forced worldwide combination is not declared unconstitutional. The rejection by California of the federal (and indeed international) mandate of arm's length/separate accounting to divide international income for tax purposes and the State's substitute imposition of forced worldwide combination, has culminated in threats and acts of retaliation from 1978 forward of a magnitude beyond that previously experienced in this country. As documented in the *Barclays* trial record and acknowledged by the California Court of Appeal (a point completely ignored by the California Supreme Court), diplomatic protests were lodged with the United States by almost every developed country in the world, including direct protestations by Prime Minister Thatcher of the United Kingdom, Prime Minister Nakasone of Japan, and Prime Minister Trudeau of Canada directly to the President. The United States experienced significant problems in negotiating treaties with the Dutch and Germans, due to those countries' disfavor of California's taxing method. The Canadian and French treaty negotiators insisted on an exchange of notes which obligated the United States to reopen discussion with each country on the subject whether an acceptable solution could be devised. Trial Exs. 1 pp. 28-29, 32A, 32EE, 37F, 43, 46D, 46H, 72; Ct. of App. Slip. Op. at p. 40.

Madison and Hamilton's predictions two centuries ago were correct. The strongest reactions to and retaliatory measures against California's use of forced worldwide combination were registered by Great Britain, the nation whose commerce and trade strength instilled the greatest fear in the drafters of the foreign Commerce Clause. Great Britain followed up its early diplomatic efforts with respect to the aberrant California situation with the en-

actment in 1985 of retaliatory legislation that would deny certain previously agreed-upon treaty benefits to United States corporations operating in unitary states. At that time, the only recourse for American businesses to avoid the effect of such legislation—*i.e.*, not repatriating the dividends of United Kingdom subsidiaries—was unsatisfactory or harmful to their business operations, from the viewpoint of many. The passage of the water's edge legislation by California in 1988 stayed the implementation of Great Britain's retaliatory legislation but the threat of the implementation remained and was brought into play in 1993. Great Britain then notified targeted business entities as to the means and effect of implementation and United States corporations were faced with the economic burden of the proposed retaliation.

What are the ramifications of foreign retaliation against a state's unconstitutional taxing method for COST's member companies? Ensuring international, federal and state tax compliance becomes impossible. If companies are forced to devise alternative contingency plans to accommodate their shifting duties and liabilities every time a state taxing measure provokes threatened or real international retaliation, the evaluation of ongoing business and the evaluation of business opportunities becomes a guessing game rather than a business analysis. The ability to operate at all in various foreign countries often hinges on the nature of relations between the United States and such countries from moment to moment. The foreign Commerce Clause is the only shield domestic corporations can raise against the brunt of foreign economic retaliation that is deflected from the errant state and falls on corporations which have no culpable ties to the state.

The forced use of worldwide combined reporting is especially offensive to foreign nations and multinational businesses because it is wholly unnecessary. The entire world, with the exception of six states of the United States, manages to operate effective tax systems without thrusting

onerous record-keeping and compliance requirements on entities with no transactional or legal contact with the state that would impose those requirements. This Court has stated that as between arm's length separate accounting and worldwide combination there is little to recommend one system over the other. *See Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 184-185 (1983). Whatever merit that conclusion may have in other contexts, in the context of foreign commerce there are at least three circumstances that favor the use of arm's length separate accounting. First, it is the method chosen by every national government, so its use is not capable of giving rise to any objection by any trading partner. Second, it is least likely to impinge on the sovereignty of any other nation because it concerns itself only with those transactions that by their cross-border nature invite that concern; it does not impose accounting and compliance burdens on entities whose activities have no contact with the taxing jurisdiction. Third, it is the method that the actions of the United States have led its trading partners to believe will be used to determine all tax liabilities and compliance requirements in the United States.

II. FORCED WORLDWIDE COMBINED REPORTING IS BEING UTILIZED BY SEVERAL STATES RATHER THAN INTERNATIONALLY SANCTIONED TOOLS; IN NO CASE IS THE METHOD EITHER NECESSARY OR JUSTIFIABLE

The practical importance of the question whether forced worldwide unitary combination is constitutional remains unabated by a state's "hit and run" ploy of instituting an unconstitutional tax measure and later repealing or reforming such legislation on the eve of (i) retaliatory action by a foreign nation or (ii) plenary judicial review by a state supreme court or by this Court. Although the Solicitor General claims to view *Barclays* as lacking "substantial recurring importance." *Am.* U.S. Br. No. 92-1384,

due to the State's enactment of water's edge legislation, this perspective is willfully myopic. In fact, the actual and potential utilization of worldwide combined reporting by states in addition to California continues to threaten the well-being of domestic business in the context of the world marketplace.

Alaska imposes forced worldwide combination on oil and gas companies. ALASKA STAT. § 43.20.073(f). Tennessee imposes worldwide combination on financial institutions. TENN. CODE ANN. § 67-4-817(d). While an election out of worldwide combination is available in Idaho, Montana, North Dakota and Utah, specific features of these states' methods may in effect force corporate taxpayers back into worldwide combined reporting, or include select foreign affiliates in the combined group. For instance, the Idaho State Tax Commission may disregard a water's edge election if any corporation is deemed to have failed to comply with the domestic disclosure spreadsheet requirement or the State's legal and procedural requirements. IDAHO CODE § 63-3027B(c). *See also* MONT. ADMIN. R. 42.26.224; *cf.* N.H. REV. STAT. ANN. § 77-A:6, IV. North Dakota includes foreign corporations in a unitary group that files a water's edge election, if over 50% of the voting stock of the foreign corporations is owned directly or indirectly by an affiliated corporation and more than 20% of the average of its payroll and property is assignable to locations in the United States (not specifically North Dakota). N.D. CENT. CODE §§ 57-38.4-01 and 57-28.4-02. Effective taxable years beginning on or after January 1, 1994, Utah includes 100% of a foreign operating company's income (prior law included 50%) on a water's edge combined report. UTAH CODE ANN. § 59-7-304(1).

Each of the above-referenced states has a tool or a policy which it could effectively utilize to reach income that has been shifted to an inappropriate taxing jurisdiction. These means may be utilized without encroaching on the

sovereignty of other nations and precipitating the retaliation that would attend that encroachment. As noted above, this tool has been sanctioned by the entire world.

CONCLUSION

For the reasons set forth above, the Committee on State Taxation respectfully requests that the decisions of the California Supreme Court in *Barclays* and *Colgate-Palmolive* be reversed.

Respectfully submitted,

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